

Message Text

LIMITED OFFICIAL USE

PAGE 01 LONDON 11607 01 OF 03 261704Z

46

ACTION EUR-12

INFO OCT-01 EA-07 IO-13 ISO-00 EB-07 USIE-00 INRE-00 SSO-00

NSCE-00 AID-05 CIAE-00 FRB-03 INR-07 NSAE-00 XMB-02

OPIC-03 SP-02 CIEP-01 LAB-04 SIL-01 OMB-01 NSC-05

SS-15 STR-04 CEA-01 L-03 H-02 AGR-05 FEAE-00 INT-05

ITC-01 NEA-10 EURE-00 /120 W
----- 019917

O R 261639Z JUL 76

FM AMEMBASSY LONDON

TO TREASURY DEPT WASHDC IMMEDIATE

SECSTATE WASHDC 3963

INFO AMEMBASSY BONN

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

AMCONSUL BELFAST

AMCONSUL EDINBURGH

USMISSION EC BRUSSELS

USMISSION OECD PARIS

USDEL MTN GENEVA

USDOC WASHDC

LIMITED OFFICIAL USE SECTION 01 OF 03 LONDON 11607

DEPARTMENT PASS FRB

TREASURY FOR DONALD SYVRUD, OASIA

E.O. 11652: N/A

TAGS: ECON, UK, EFIN, EAID

SUBJECT: FURTHER COMMENTARY ON THE ECONOMIC IMPLICATIONS
OF THE CHANCELLOR'S LATEST PACKAGE

REF: LONDON 11463

LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 02 LONDON 11607 01 OF 03 261704Z

SUMMARY: THE CHANCELLOR'S PUBLIC SPENDING CUTS AND INCREASE IN THE EMPLOYER'S CONTRIBUTION TO NATIONAL INSURANCE HAVE RECEIVED A MIXED RECEPTION. THE MEASURES MEAN SLOWER GROWTH, MORE UNEMPLOYMENT, HIGHER BUSINESS COSTS, SOME IMPROVEMENT IN THE BALANCE OF PAYMENTS. PUBLIC SECTOR BORROWING REQUIREMENT IN THE NEXT FINANCIAL YEAR WILL BE REDUCED. FIRM QUANTITATIVE ESTIMATES, HOWEVER, ARE PROBLEMATIC. END SUMMARY.

1. EMBASSY OFFICERS HAVE QUERIED TREASURY, BANK OF ENGLAND AND CBI OFFICIALS CONCERNING THE CHANCELLOR'S PACKAGE OF MEASURES. THE CHANCELLOR'S (I.E., HMT'S) ESTIMATES ARE THAT THE ENTIRE PACKAGE OF MEASURES ANNOUNCED LAST THURSDAY (SEE LONDON 11463) WILL OVER THE 18 MONTHS FROM THE FIRST HALF OF 1976. REDUCE THE ANNUAL RATE OF INCREASE OF GDP FROM 5 TO 4-1/2 PERCENT AND THE RATE OF GROWTH OF MANUFACTURING PRODUCTION FROM 9 TO ABOUT 8.1/2 PERCENT. THE CHANCELLOR INDICATED THAT THE MEASURES WOULD REDUCE THE FALL IN UNEMPLOYMENT BY EARLY 1978 BY ABOUT 60,000, BUT SOME TRADE UNION OFFICIALS WHO ARE ALSO FOCUSSED ON THE INCREASE IN THE EMPLOYER'S NATIONAL INSURANCE CONTRIBUTION (FROM 8-3/4 TO 10-3/4 PERCENT, I.E., AN INCREASE OF A BILLION POUNDS IN WHAT IS EFFECTIVELY THE PAYROLL TAX) CONSIDER THAT THE TOTAL UNEMPLOYMENT RESULTING FROM THE PACKAGE (OR FAILURE TO REEMPLOY, AS THE CASE MAY BE) COULD BE AS HIGH AS 120,000.

2. BUSINESS FIRMS ARE NOT PLEASED WITH THE TAX WHICH ADDS TO THEIR COSTS AT A TIME WHEN IT IS IMPERATIVE TO REBUILD PROFITS AND INCREASE INVESTMENT. SOME NOTE THE CHANCELLOR'S POINT THAT UNDER HALF OF THE INCREASED TAKE (OF 910 MILLION POUNDS IN FY 77/78 AND ABOUT 1.03 BILLION POUNDS IN A FULL YEAR) WILL COME FROM THE MANUFACTURING SECTOR. THE SERVICE SECTOR WILL ALSO HAVE ITS COSTS INCREASED. HOWEVER, THE EXTRA COSTS CAN BE PASSED THROUGH IN HIGHER PRICES. IN ADDITION, AMENDMENTS TO THE PRICE CODE WITH REVISIONS TO INVESTMENT RELIEF (UP FROM 20 PERCENT TO 50 PERCENT) AND THE INCREASE IN THE ADJUSTMENT FACTOR FOR DEPRECIATION FROM 1.3 TO 1.4 CAN ALSO OFFSET THE ADDITIONAL PAYROLL TAX. NONETHELESS, THE ULTIMATE LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 03 LONDON 11607 01 OF 03 261704Z

EFFECT MUST BE TO INCREASE UNIT COSTS ABOVE WHAT THEY WOULD HAVE BEEN, THEREBY MAKING FINAL COSTS AND PRICES -- INCLUDING EXPORT PRICES - MORE EXPENSIVE.

3. IN A PERIOD OF ECONOMIC UPTURN, THERE IS A FAIR PROBABILITY THAT THE COST INCREASES LARGELY WILL BE PASSED ON. INTERNAL HMT FORECASTS SHOW MANUFACTURING INVESTMENT PROJECTED TO RISE OVER 20 PERCENT DURING 1977. THE ADDI-

TIONAL PRICE CODE CONCESSIONS SHOULD THEREFORE BE MEANINGFUL. THE CHANCELLOR'S ESTIMATE IS THAT THE TOTAL IMPACT OF HIS PACKAGE ON PRICES WILL BE TO INCREASE THE PRICE LEVEL BY ABOUT 1 PERCENT BY MARCH 1978.

4. SOURCES WITHIN HMTREASURY EXPRESS DISAPPOINTMENT AT PRESS AND MARKET REACTION TO THE CHANCELLOR'S PROGRAM. AS NEARLY AS WE CAN TELL, A FAIR AMOUNT OF IN-FIGHTING WENT ON BETWEEN HMT AND BOE OFFICIALS IN PUTTING TOGETHER THE PACKAGE. THE INCREASE IN THE NATIONAL INSURANCE CONTRIBUTION I.E.. PAYROLL TAX HAD BEEN PROPOSED EARLIER BY SENIOR STAFF FOR INCLUSION IN LAST APRIL'S BUDGET IN AN ATTEMPT TO BRING DOWN THE PSBR IN THIS FISCAL YEAR. THEY WERE OF COURSE UNSUCCESSFUL IN THOSE ATTEMPTS. THE

LIMITED OFFICIAL USE

NNN

LIMITED OFFICIAL USE

PAGE 01 LONDON 11607 02 OF 03 261706Z

46

ACTION EUR-12

INFO OCT-01 EA-07 IO-13 ISO-00 EB-07 SSO-00 NSCE-00 USIE-00

INRE-00 AID-05 CIAE-00 FRB-03 INR-07 NSAE-00 XMB-02

OPIC-03 SP-02 CIEP-01 LAB-04 SIL-01 OMB-01 NSC-05

SS-15 STR-04 CEA-01 L-03 H-02 AGR-05 FEAE-00 INT-05

ITC-01 NEA-10 EURE-00 /120 W
----- 019924

O R 261639Z JUL 76

FM AMEMBASSY LONDON

TO TREASURY DEPT WASHDC IMMEDIATE

SECSTATE WASHDC 3964

INFO AMEMBASSY BONN

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

AMCONSUL BELFAST

AMCONSUL EDINBURGH

USMISSION EC BRUSSELS

USMISSION OECD PARIS

USDEL MTN GENEVA
USDOC WASHDC

LIMITED OFFICIAL USE SECTION 02 OF 03 LONDON 11607

TAX NEEDS ROUGHLY 6 MONTHS PREPARATION IN ORDER THAT FIRMS CAN READJUST THEIR PAYROLL COMPUTERS. IT ALSO REQUIRES LEGISLATION, BUT IT IS SEEN AS A TREMENDOUS REVENUE RAISER AND FAR LESS VISIBLE THAN AN INCREASE IN THE VALUE ADDED TAX, THE MOST LIKELY ALTERNATIVE. THIS WAS THE MAIN ARGUMENT ADVANCED BY THOSE IN FAVOR OF IT. OTHER HMT OFFICIALS ARGUED CORRECTLY THAT IT WOULD BE SEEN AS RENEGING ON THE GOVERNMENT'S INDUSTRIAL STRATEGY AIMED AT FOS-

LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 02 LONDON 11607 02 OF 03 261706Z

TERING MANUFACTURING PRODUCTION AND INVESTMENT AND REDUCING COSTS.

5. THE POINT THAT CARRIED THE DAY WAS THE WIDELY SHARED VIEW THAT THE CHANCELLOR'S PROPOSED PUBLIC EXPENDITURE CUTS OF 952 BILLION POUNDS IN THEMSELVES WERE NOT SUFFICIENT TO BRING DOWN THE PSBR SUFFICIENTLY TO INFLUENCE THE FOREIGN EXCHANGE MARKETS. THIS ALSO WAS THE RATIONALE FOR CONSIDERATION OF MONETARY GROWTH TARGETS AND FOR THE INCLUSION IN THE MESSAGE OF AN INDICATION THAT FOR THE CURRENT FINANCIAL YEAR, MONEY SUPPLY GROWTH SHOULD AMOUNT TO ABOUT 12 PERCENT. THE AIM WAS TO REASSURE FINANCIAL MARKETS OF THE CHANCELLOR'S RESOLVE NOT TO ALLOW THE GROWTH OF MONEY SUPPLY TO FUEL INFLATION EITHER THIS YEAR OR NEXT.

6. THE PROPOSED PUBLIC EXPENDITURE CUTS LINKED WITH THE INCREASE IN PAYROLL TAX WILL REDUCE THE PUBLIC SECTOR BORROWING REQUIREMENT IN FY 1977/78 BY 800 MILLION AND 700 MILLION POUNDS' RESPECTIVELY. BRINGING THE PROJECTED PSBR DOWN TO 9 BILLION POUNDS. TREASURY FORECASTERS SEE THIS AS MEANINGFUL IN ECONOMIC IMPACT AS WELL AS NECESSARY TO FREE RESOURCES FOR THE BALANCE OF PAYMENTS AND EASING BORROWING PRESSURE ON THE FINANCIAL MARKETS. BEYOND THIS THOUGH THEY ARE VERY CIRCUMSPECT IN PUTTING NUMBERS ON THEIR QUALITATIVE ASSESSMENTS. THE CURRENT ACCOUNT DEFICIT IN THE BALANCE OF PAYMENTS IN THE FIRST HALF OF 1976 IS RUNNING AT 1.3 BILLION POUNDS. HOWEVER, GIVEN THE DETERIORATION FROM THE FIRST QUARTER (MINUS 60) TO THE SECOND QUARTER (MINUS 574). THEY NOTE THAT SHOULD THE CURRENT BALANCE REMAIN IN DEFICIT FOR THE REST OF THE YEAR AT THE SECOND QUARTER LEVEL. THE DEFICIT WOULD BE IN THE

RANGE OF 1.8 BILLION POUNDS. PRIVATELY, THEY CONSIDER THAT THE DEFICIT WILL BE TOWARD THE UPPER END OF THE RANGE, NOTING RESTOCKING AND SPECIAL FACTORS SUCH AS LARGE NORTH SEA OIL EQUIPMENT PAYMENTS IN THE 2ND AND 3RD QUARTERS. SHOULD IMPORTS OF FINISHED MANUFACTURED GOODS JUMP SHARPLY, THIS WOULD BE A MORE SERIOUS CONCERN

7. WHEN DISCUSSING NEXT YEAR'S POSSIBLE BALANCE OF PAYMENTS OUTCOME, SOURCES INDICATE A WIDE RANGE OF ERROR LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 03 LONDON 11607 02 OF 03 261706Z

AND UNCERTAINTIES THAT INCLUDE EXPORT ELASTICITIES (CURRENTLY ESTIMATED AT 0.6) IMPORT ELASTICITIES (ESTIMATED AT 1.8); TERMS OF TRADE THAT ARE UNCERTAIN GIVEN COMMODITY TRENDS; BUT ALSO A FEELING THAT U.K. GOODS ARE NOW AS COMPETITIVE IN INTERNATIONAL MARKETS AS THEY ARE EVER GOING TO BE IMPORTS ASSOCIATED WITH NORTH SEA OIL DEVELOPMENT ARE EXPECTED TO DECLINE WHILE THE IMPORT SUBSTITUTION VALUE OF NORTH SEA OIL ITSELF INCREASES MARKEDLY. NORTH SEA PAYMENTS FOR INTEREST, PROFITS AND DIVIDENDS SHOULD INCREASE ON BALANCE, THE OFFICIAL FORECASTERS SAY THEY ANTICIPATE THE OUTCOME IN 1977 SHOULD BE BETTER THAN IN 1976 BUT THEY ARE NOT WILLING TO COMMIT THEMSELVES TO BE AS OPTIMISTIC AS THE NATIONAL INSTITUTE WHICH IS FORECASTING A CURRENT DEFICIT OF 900 MILLION POUNDS.

8. AS YET, THERE HAS NOT BEEN ANY SERIOUS ACADEMIC CRITIQUE. A RECENT CAMBRIDGE UNIVERSITY STUDY BY TERRY WARD AND ROBERT NEILD ESTIMATED THAT ON A FULL EMPLOYMENT BASIS (DEFINED AS 650,000 UNEMPLOYED AND CURRENT ACCOUNT EQUILIBRIUM) THE 1976/77 BUDGET DEFICIT WAS EQUAL TO ABOUT 5 PERCENT OF GNP. BASED ON UNCHANGED POLICIES, IT FORECASTS A PUBLIC SECTOR FINANCIAL SURPLUS ON A FULL EMPLOYMENT BASIS WITHIN TWO YEARS. IF ONE ACCEPTS THEIR ANALYSIS, THE CUTS JUST ANNOUNCED SHOULD MOVE FORWARD THE DATE WHEN ON A FULL EMPLOYMENT BASIS THE PUBLIC SECTOR CEASES TO BE A STIMULATIVE INFLUENCE ON THE ECONOMY. IN THAT EVENT, A GOVERNMENT DEFICIT WOULD RESULT FROM UNEMPLOYMENT ABOVE 650,000.

9. THE WEEKEND PRESS CARRIES WHAT APPEAR TO BE INSPIRED ARTICLES TO THE EFFECT THAT THE CHANCELLOR HAS NOW DONE ALL THAT HE CAN AND THAT ADDITIONAL REQUESTS FOR CUTS IN CONNECTION WITH POTENTIAL IMF BORROWINGS WILL BE REFUSED. THE PRESS MESSAGE COMING ACROSS SEEMS TO BE THAT THE U.K

LIMITED OFFICIAL USE

NNN

LIMITED OFFICIAL USE

PAGE 01 LONDON 11607 03 OF 03 261705Z

46

ACTION EUR-12

INFO OCT-01 EA-07 IO-13 ISO-00 EB-07 SSO-00 NSCE-00 USIE-00

INRE-00 AID-05 CIAE-00 FRB-03 INR-07 NSAE-00 XMB-02

OPIC-03 SP-02 CIEP-01 LAB-04 SIL-01 OMB-01 NSC-05

SS-15 STR-04 CEA-01 L-03 H-02 AGR-05 FEAE-00 INT-05

ITC-01 NEA-10 EURE-00 /120 W
----- 019994

O R 261639Z JUL 76

FM AMEMBASSY LONDON

TO TREASURY DEPT WASHDC IMMEDIATE

SECSTATE WASHDC 3965

INFO AMEMBASSY BONN

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

AMCONSUL BELFAST

AMCONSUL EDINBURGH

USMISSION EC BRUSSELS

USMISSION OECD PARIS

USDEL MTN GENEVA

USDOC WASHDC

LIMITED OFFICIAL USE SECTION 03 OF 03 LONDON 11607

AND THE CHANCELLOR HAVE DONE ALL THAT CAN BE DONE POLITICALLY: ANY FURTHER MEASURES OF A RESTRICTIVE NATURE WOULD LIKELY BE IN THE FORM OF IMPORT AND FOREIGN EXCHANGE CONTROLS RATHER THAN PUBLIC EXPENDITURE CUTS. IN HIS MESSAGE, THE CHANCELLOR CERTAINLY LEFT THE DOOR OPEN FOR EXTENDING SELECTIVE IMPORT RESTRAINTS.

10. GENERAL PRESS REACTION HAS BEEN MODERATELY FAVORABLE
LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 02 LONDON 11607 03 OF 03 261705Z

BUT CARRYING CRITICISM AS WELL. FOR EXAMPLE. A SUNDAY TIMES EDITORIAL CRITICIZED THE NATURE OF THE CUTS ON GOVERNMENT CAPITAL INVESTMENT AND THE DECISION TO INCREASE THE NATIONAL INSURANCE CONTRIBUTION. THE TIMES ASKS: QUOTE: WHOSE HAND, ONE MUST ASK. IS ON THE TILLER? HAS HEALEY YIELDED IT TO WILLIAM SIMON, SECRETARY OF THE U.S. TREASURY, AND TO THE INTERNATIONAL MONETARY FUND AS THE PRICE FOR RENEWAL OF OUR 5.3 BILLION DOLLAR SIX-MONTH CREDIT ARRANGEMENT? THAT SUSPICION. AMONG OTHERS, HAS TO BE VOICED BECAUSE THE CUTS ARE SO BEWILDERINGLY ILL-JUDGED IN THEIR COMPOSITION. SLASH SOMETHING TO APPEASE THE FOREIGN BANKER. ESPECIALLY SOMETHING WITH HIGH EMOTIONAL CONTENT SUCH AS CHARGES FOR TEETH AND GLASSES, AND AND THEN AS THE LEFT PREPARES TO SQUEAL APPEASE THEM. TOO, WITH A LEFT AND A RIGHT TO INDUSTRY. WHAT IS GOING ON?

IT IS TRUE THAT OUR INDEBTEDNESS MEANS WE HAVE TO LISTEN TO OUR CREDITORS; BUT IT IS NOT IN THEIR INTEREST OR OURS THAT WE SHOULD COMMIT FOLLIES IN AREAS WHERE WE HAVE GREATER KNOWLEDGE OF OUR PROBLEMS AND OPPORTUNITIES. ... END QUOTE

11. LEAVING ASIDE THE NATURE OF THE CUTS, SOURCES IN HMT INFORMALLY MAKE TWO POINTS. FIRST. THE IMPACT OF THE ENTIRE PACKAGE ON THE PSBR IN THE NEXT FISCAL YEAR WILL BE SIGNIFICANT AND COULD BE GREATER THAN THE 1.5 BILLION POUNDS STATED BY THE CHANCELLOR. ONE SOURCE LACKS TOTAL FAITH IN WHAT ONE CALLS THE TREASURY'S "DAMN MODEL" WHICH TAKES LITTLE ACCOUNT OF MONETARY EFFECTS, ONLY REAL

HOWEVER, THIS OFFICIAL AND OTHERS ARE CURRENTLY "MUCH MORE OPTIMISTIC" ABOUT THE BALANCE IN THE ECONOMY NEXT YEAR. THE OUTLOOK FOR INDUSTRIAL PERFORMANCE AND AVOIDING CROWDING OUT THAN THEY WERE PRIOR TO THE CHANCELLOR'S MESSAGE LAST THURSDAY. SOME BOE AND HMT OFFICIALS, EVEN BEFORE THE MESSAGE, HAD INDICATED THAT THEY FELT THE FOREIGN EXCHANGE MARKET HAD ALREADY "COMPLETELY DISCOUNTED" THE PACKAGE. THEIR HOPE IS THAT THE MARKET'S REACTION WILL BE NEUTRAL RATHER THAN NEGATIVE.

ARMSTRONG

LIMITED OFFICIAL USE

NNN

Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: EXPENDITURES, CURRENCIES, TAXES, CURRENCY CONTROLS, BUDGET DATA
Control Number: n/a
Copy: SINGLE
Draft Date: 26 JUL 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: morefirh
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976LONDON11607
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D760287-0048
From: LONDON
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19760722/aaaaatca.tel
Line Count: 375
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EUR
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 7
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: 76 LONDON 11463
Review Action: RELEASED, APPROVED
Review Authority: morefirh
Review Comment: n/a
Review Content Flags:
Review Date: 01 APR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <01 APR 2004 by greeneet>; APPROVED <02 APR 2004 by morefirh>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: FURTHER COMMENTARY ON THE ECONOMIC IMPLICATIONS OF THE CHANCELLOR'S LATEST PACKAGE
TAGS: ECON, EFIN, EAID, UK
To: TRSY STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006